

## Message Text

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PAGE 01 OECD P 02127 01 OF 03 211846Z  
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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE  
(EDRC) REVIEW OF NETHERLANDS

REF: EDR(77)2

1. SUMMARY: IN REFDOC CIRCULATED FOR JAN. 27 EDRC  
REVIEW OF NETHERLANDS, SECRETARIAT CHARACTERIZES  
EVOLUTION OF DUTCH ECONOMY IN 1976 AS "SOMEWHAT DIS-  
APPOINTING", DESPITE HIGHER THAN EXPECTED RATE OF GDP  
GROWTH AND DECELERATION OF INFLATION. SECRETARIAT  
CONSIDERS OFFICIAL GON FORECASTS FOR 1977 TO BE OVERLY  
OPTIMISTIC AND PROJECTS MODERATE (3 - 3.5 PERCENT)  
GROWTH OF GDP, AND NO FALL IN UNEMPLOYMENT RATE,  
ACCOMPANIED BY FURTHER IMPROVEMENT IN PRICE PERFORMANCE  
AND INCREASE IN CURRENT ACCOUNT SURPLUS. SECRETARIAT  
NOTES THAT GON DEMAND MANAGEMENT POLICIES WERE  
EXPANSIONARY IN 1976 AND ARE LIKELY TO BE LESS SO IN  
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PAGE 02 OECD P 02127 01 OF 03 211846Z

1977, BUT DOES NOT COMMENT EXTENSIVELY ON APPROPRIATENESS  
OF GON POLICY STANCE. RATHER SECRETARIAT FOCUSES ON  
ANALYSIS OF CURRENT REORIENTATION OF GON POLICIES WHOSE  
OBJECTIVE IS STIMULATION OF PRIVATE (NON-RESIDENTIAL)  
INVESTMENT AND SHRINKAGE OF SHARE OF PUBLIC SECTOR IN  
GDP OVER MEDIUM TERM. SECRETARIAT CONSIDERS SHIFT  
DESIRABLE. SECRETARIAT ALSO URGES GON TO (A) PERSEVERE

IN ITS EFFORT TO DEVELOP "SOCIAL CONSENSUS" TO LIMIT WAGE/PRICE INCREASES AND (B) TO STAND READY (FOR NATIONAL AND INTERNATIONAL REASONS) TO INJECT FURTHER STIMULUS IF NEED ARISES. ACTION REQUESTED: MISSION WOULD APPRECIATE COMMENTS/QUESTIONS WHICH COULD BE USEFULLY POSED AT REVIEW. FOR HAGUE: MISSION WOULD WELCOME EMBASSY COMMENTS ON SECRETARIAT ANALYSIS AND CONCLUSIONS AS WELL AS PARTICIPATION BY EMBASSY REP IN REVIEW. END SUMMARY

2. SHORT TERM PROSPECTS; DOMESTIC OUTLOOK: LED BY EXPORTS AND SUPPORTED BY EXPANSIONARY FISCAL POLICIES AND GROWTH OF PRIVATE CONSUMPTION, NETHERLANDS ECONOMY SHOWED STRONG RECOVERY FROM RECESSION IN LATE 1975. SECRETARIAT'S JUDGMENT IS THAT DURING 1976 GROWTH OF GDP WAS MODEST AND ERRATICALLY DISTRIBUTED. INVESTMENT WEAKENED CONSIDERABLY IN 1976, WHILE GROWTH OF EXPORT VOLUMES AND DEGREE OF FISCAL STIMULUS DECLINED OVER COURSE OF YEAR. NONETHELESS, SECRETARIAT ESTIMATES THAT GDP GROWTH ACCELERATED SOMEWHAT BETWEEN FIRST AND SECOND HALVES OF 1976 AND PLACES AVERAGE ANNUAL GROWTH RATE AT 3.5 PERCENT (VS. GON FORECAST OF 2.5 PERCENT, AND SECRETARIAT PROJECTION OF 2.25 PERCENT). ACCORDING TO SECRETARIAT, SLOW GROWTH OF DOMESTIC DEMAND (AND WAGE/PRICE CONTROLS) CONTRIBUTED TO DECLINE IN INFLATION RATE FROM 1975 LEVELS BUT ALSO RESULTED IN CONTINUED WEAKNESS IN LABOR MARKET.

3. 1977 OUTLOOK: SECRETARIAT INDICATES THAT LATEST (SEPT 1976) GON OFFICIAL FORECASTS ENVISAGE GDP GROWTH LIMITED OFFICIAL USE

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PAGE 03 OECD P 02127 01 OF 03 211846Z

OF 4.1 PERCENT IN 1977, WITH FOLLOWING MAIN POSITIVE ELEMENTS (A) ACCELERATION OF COMMODITY EXPORTS (8.5 PERCENT); (B) STRONG PICKUP IN PRIVATE (NON-RESIDENTIAL) INVESTMENT (8 PERCENT); (C) LARGE CONTRIBUTION FROM INVENTORY FORMATION AND (D) MODERATE GROWTH OF PRIVATE CONSUMPTION (3 PERCENT). SECRETARIAT FEELS THAT GON HAS OVERESTIMATED GROWTH OF ITS EXPORT MARKETS (SEE PARA 5 BELOW) AND NOTES THAT SLOWER GROWTH OF EXPORTS WOULD HAVE DAMPENING EFFECT ON PRIVATE CONSUMPTION AND THEREFORE CONSIDERS 3 PERCENT GON FORECAST TO BE UPSIDE LIMIT. SIMILARLY, SECRETARIAT COMMENTS THAT WHILE EFFECT OF INVESTMENT STIMULATION MEASURES ARE HARD TO EVALUATE, LOW PROFITS AND EXCESS CAPACITY WILL MILITATE AGAINST REALIZATION OF GON FORECAST FOR GROWTH OF INVESTMENT. SECRETARIAT ADDS THAT FISCAL POLICY (INCLUDING INVESTMENT STIMULUS) COULD HELP GDP GROWTH, BUT THAT GON FORECAST OF STOCK MOVEMENTS IS PROBABLY ON HIGH SIDE. SECRETARIAT PROJECTS REAL GDP GROWTH OF 3 - 3.5 PERCENT IN 1977 AND THUS FEELS THAT DECLINE IN

UNEMPLOYMENT RATE IS UNLIKELY.

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PAGE 01 OECD P 02127 02 OF 03 211847Z

ACTION EUR-12

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4. PRICES: SECRETARIAT OBSERVES THAT SLOW GROWTH OF IMPORT PRICES, POSSIBLE DECLINE OF FOOD PRICES AND EFFECT OF STRICT PRICE CONTROLS WILL CONTRIBUTE TO FURTHER DECELERATION OF INFLATION RATE IN 1977. HOWEVER, IT NOTES THAT CONSIDERABLE UNCERTAINTY SURROUNDS EVOLUTION OF WAGE COSTS THIS YEAR SINCE, AT TIME REFDOC WAS DRAFTED, CENTRALIZED WAGE NEGOTIATIONS HAD AGAIN BROKEN DOWN AND NO CLEAR INDICATIONS EXISTED AS TO LIKELY OUTCOME OF SECTORAL BARGAINING PROCESS. ON ASSUMPTION OF 8 - 8.5 PERCENT INCREASE OF AVERAGE (PER EMPLOYEE) WAGES, SECRETARIAT FORECASTS LESS THAN 7 PERCENT RISE IN CONSUMER PRICES--SMALLEST INCREASE SINCE 1970.

5. CURRENT ACCOUNT: IN ITS FORECAST OF 8.5 PERCENT GROWTH OF EXPORT VOLUMES IN 1977 GON ASSUMES: (A) 8 PERCENT GROWTH OF MARKETS; (B) NO GUILDER APPRECIATION; (C) DECLINE OF RELATIVE UNIT LABOR COSTS (IN GUILDERS). SECRETARIAT STATES THAT CURRENCY REALIGNMENTS WITHIN LIMITED OFFICIAL USE

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PAGE 02 OECD P 02127 02 OF 03 211847Z

"SNAKE" IN OCTOBER IMPLY THAT EFFECTIVE GUILDER RATE WILL SECRETARIAT FORECASTS NO CHANGE IN DUTCH RELATIVE UNIT LABOR COSTS THIS YEAR, AND 6.25 PERCENT GROWTH OF DUTCH EXPORT MARKETS, AND CONCLUDES THAT GON EXPORT VOLUME FORECASTS ARE ON HIGH SIDE. SECRETARIAT ALSO FORESEES SLOWER GROWTH OF IMPORT VOLUMES AND OF IMPORT PRICES THAN DOES GON AND PROJECTS CURRENT ACCOUNT SURPLUS OF 7 BILLION GUILDER IN 1977 COMPARED TO ESTIMATED SURPLUS OF 6 BILLION GUILDER IN 1976.

6. ECONOMIC POLICY: SECRETARIAT NOTES THAT MAIN OBJECTIVE OF GON DEMAND MANAGEMENT POLICIES WAS SUPPORT OF RECOVERY, WHILE DIRECT CONTROLS WERE EMPLOYED TO COMBAT WAGE/PRICE INFLATION. IT EXPECTS NET ECONOMIC IMPACT OF GOVERNMENT PURCHASES OF GOODS AND SERVICES TO BE ZERO OR NEGATIVE IN 1977, BUT ADDS THAT SPENDING UNDER INVESTMENT STIMULUS PROGRAM SHOULD BRING ABOUT POSITIVE PUBLIC SECTOR INFLUENCE ON GDP GROWTH. SECRETARIAT STATES THAT GOALS OF GON MONETARY POLICY HAVE BEEN TO SUPPORT UPSWING, TO ENSURE FINANCING OF PUBLIC SECTOR DEFICIT WITHOUT GENERATING EXCESSIVE LIQUIDITY, AND TO MAINTAIN NET OUTFLOW OF LONG TERM CAPITAL IN ORDER TO PREVENT UPWARD PRESSURE ON GUILDER. SECRETARIAT INDICATES THAT M2 ROSE RAPIDLY IN 1976 AND THAT BY OCTOBER LAST YEAR, RATIO OF M2 TO NET NATIONAL INCOME STOOD AT 41 PERCENT - A RECORD FIGURE.

7. MEDIUM TERM PROBLEMS AND POLICIES: SECRETARIAT DEVOTES CONSIDERABLE ATTENTION IN REFDOK TO ANALYSIS OF DUTCH MEDIUM TERM PROBLEMS AND TO GON POLICY RESPONSE TO THEM. SECRETARIAT OBSERVES THAT SINCE 1970 DUTCH ECONOMY HAS BEEN CHARACTERIZED BY STAGNATION OF PRIVATE INVESTMENT SPENDING, FALLING RATES OF RETURN ON INVESTMENT, RAPID INFLATION AND INCREASE IN SIZE OF PUBLIC SECTOR. SECRETARIAT FEELS THAT ROOT CAUSE OF THESE CONDITIONS WAS GON ATTEMPT TO EXPAND

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PAGE 03 OECD P 02127 02 OF 03 211847Z

SOCIAL WELFARE SYSTEM IN ADVANCE OF CAPABILITY OF PRODUCTIVE BASE TO PAY FOR IT. RESULT WAS RISING TAX BURDEN (PARTICULARLY ON FIRMS) AND INFLATION GENERATED BY STRUGGLE AMONG GROUPS TO MAINTAIN INCOME SHARES IN FACE OF RELATIVE INCREASE IN SIZE OF PUBLIC SECTOR. SECRETARIAT NOTES THAT GON REACHED SIMILAR CONCLUSIONS AND AS A RESULT HAS ADOPTED TWO-PRONGED POLICY RESPONSE: (A) 1 PERCENT POLICY - CLAIM OF

PUBLIC SECTOR, IN TERMS OF TAX AND NON-TAX REVENUE  
(OTHER THAN TAX ON NATURAL GAS EXPORTS) AS PERCENTAGE  
OF NATIONAL INCOME SHOULD RISE NO MORE THAN ONE  
PERCENT PER ANNUM; (B) 2.5 BILLION GUILDER PROGRAM  
(EFFECTIVE APRIL, 1977) DIRECTLY TO STIMULATE PRIVATE  
INVESTMENT (PROGRAM WOULD TAKE FORM OF REBATES OR  
CREDITS ON CORPORATE PROFIT TAXES).

8. MAIN CONCLUSIONS: BASED ON ANALYSIS REFD  
SECRETARIAT SUGGESTS THAT EDRC REACH FOLLOWING MAIN  
CONCLUSIONS:

(A) COMBINATION OF EXPANSIONARY DEMAND MANAGEMENT WITH  
A STRICTLY APPLIED PRICES AND INCOMES POLICY HELPED TO  
SUSTAIN THE RECOVERY FROM THE 1975 RECESSION WHILE AT  
THE SAME TIME UNWINDING THE INFLATIONARY SPIRAL.

(B) NEW POLICY STRATEGY OF STIMULATING PRIVATE INVEST-  
MENT OVER A MEDIUM-TERM PERIOD SHOULD HELP TO REVERSE  
THE UNFAVORABLE TRENDS IN DOMESTIC DEMAND AND EMPLOYMENT

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PAGE 01 OECD P 02127 03 OF 03 211846Z  
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LIMITED OFFICIAL USE SECTION 03 OF 03 OECD PARIS 02127

IN EVIDENCE SINCE THE 1970S.

(C) GIVEN THE LARGE EXISTING MARGIN OF SLACK AND THE STRONG EXTERNAL POSITION, ADDITIONAL MEASURES SHOULD BE TAKEN TO VALIDATE THE NEW POLICY STRATEGY, SHOULD FOREIGN OR DOMESTIC DEMAND FALL SHORT OF GON'S SEPTEMBER EXPECTATIONS.

(D) TO ENSURE CONTINUING SUCCESS ON THE WAGE-PRICE FRONT, THERE IS A NEED TO PROMOTE A HIGHER DEGREE OF SOCIAL CONSENSUS REGARDING THE DISTRIBUTION OF REAL INCOME AND WEALTH.

9. COMMENT: (A) SECRETARIAT CONSIDERS GON INVESTMENT STIMULUS PROGRAM TO BE MAJOR STEP IN RIGHT DIRECTION. HOWEVER, SECRETARIAT ALSO INDICATES THAT UPON IMPLEMENTATION OF NEW PROGRAM, OTHER PROGRAMS TO PROMOTE INVESTMENT (E.G., ACCELERATED DEPRECIATION) WILL BE TERMINATED. MOREOVER, SECRETARIAT REFERS TO NEW GON LIMITED OFFICIAL USE

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PAGE 02 OECD P 02127 03 OF 03 211846Z

EXCESS PROFITS TAX (SO CALLED VAD TAX) UNDER WHICH "EXCESS PROFITS" OF BUSINESS WOULD BE FUNNELED INTO AN INVESTMENT FUND WHOSE EARNINGS WOULD BE USED FOR OLD-AGE PENSIONS. SECRETARIAT NOTES THAT THIS TAX HAS HAD ADVERSE EFFECT ON BUSINESS CONFIDENCE. GON APPEARS TO BE WORKING AT CROSS PURPOSES - GIVING WITH ONE HAND AND TAKING AWAY WITH THE OTHER. MISSION WOULD QUESTION DUTCH DEL ON THIS SEEMINGLY CONFLICTING APPROACH; (B) SECRETARIAT ALSO STATES THAT EXCESS PROFITS TAX IS BASED ON PRINCIPLE THAT OWNERS OF FIRMS (E.G., STOCK HOLDERS) SHOULD NOT HAVE EXCLUSIVE CLAIM ON FIRM'S PROFITS. MISSION WOULD RAISE QUESTIONS ABOUT THIS FROM VIEWPOINT THAT SUCH PRINCIPLE CAN BE RECIPE FOR MISALLOCATION OF RESOURCES. MISSION WOULD ALSO ASK DUTCH DEL WHAT CRITERIA ARE USED TO DEFINE "EXCESS PROFITS". (C) SECRETARIAT NOTES SEVERAL MEASURES TAKEN BY GON TO REDUCE GROWTH OF MONEY SUPPLY DURING 1976; YET M2 GREW AT ANNUAL RATE OF 26 PERCENT BETWEEN JANUARY AND OCTOBER. MISSION WOULD QUESTION NETHERLANDS DEL RE SOURCES OF MONETARY GROWTH IN 1976 AND ITS POSSIBLE EFFECTS ON PRICES IN 1977. TURNER

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